

No. 10037

**In the United States Circuit Court of Appeals
for the Ninth Circuit**

PACIFIC SOUTHWEST REALTY COMPANY, a CORPORATION,
PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

**ON PETITION FOR REVIEW OF THE DECISION OF THE UNITED
STATES BOARD OF TAX APPEALS**

BRIEF FOR THE RESPONDENT

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OPINION BELOW

The opinion of the United States Board of Tax Appeals (R. 37-65) is reported in 45 B. T. A. 426.

JURISDICTION

This appeal involves income taxes for the years 1936 and 1937, and is taken from a decision of the Board of Tax Appeals entered October 27, 1941 (R. 65), sustaining deficiencies in the respective amounts of \$842.75 and \$13,878.81. With respect to the year 1936 the petitioner claimed that it had overpaid its income taxes in the amount of \$53,900.53. (R. 38.) The case is brought to this Court by a petition for

review filed December 26, 1941 (R. 66-75), pursuant to the provisions of Sections 1141 and 1142 of the Internal Revenue Code.

QUESTION PRESENTED

Whether the distributions here made to the holders of petitioner's "preferred serial stock" were dividends or interest on indebtedness within the meaning of Section 23 (b) of the Revenue Act of 1936. (The deductibility of sales discounts and purchase premiums will depend upon the answer to the above question, and no separate discussion thereof is deemed necessary.)

STATUTES AND REGULATIONS INVOLVED

Revenue Act of 1936, c. 690, 49 Stat. 1648:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(b) INTEREST.—All interest paid or accrued within the taxable year on indebtedness, * * *

* * * * *

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) DEFINITION OF DIVIDEND.—The term "dividend" when used in this title * * * means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year. * * *

* * * * *

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

ART. 22 (a)-18. *Sale and purchase by corporation of its bonds.*—(1) (a) If bonds are issued by a corporation at their face value, the corporation realizes no gain or loss. (b) If the corporation purchases any of such bonds at a price in excess of the issuing price or face value, the excess of the purchase price over the issuing price or face value is a deductible expense for the taxable year. * * *

* * * *

ART. 23 (b)-1. *Interest.*—* * *

* * * *

So-called interest on preferred stock, which is in reality a dividend thereon, can not be deducted in computing net income. (See, however, article 22 (a)-18 and section 121.) In the case of banks and loan or trust companies, interest paid within the year on deposits such as interest paid on moneys received for investment and secured by interest-bearing certificates of indebtedness, issued by such bank or loan or trust company may be deducted from gross income.

* * * *

STATEMENT

Petitioner was incorporated in 1923 under the laws of Delaware by persons affiliated with the Pacific Southwest Trust & Savings Bank and the First National Bank of Los Angeles for the purpose of acquiring, and thereafter owning and operating, all of the real estate properties owned by the first mentioned bank and one parcel of real estate owned by the second

mentioned bank, and for the further purpose of providing additional bank premises as the growth of the banks required. The principal reason for organizing petitioner was to avoid "the locking up of too great a proportion" of the capital and surplus of the banks in real estate owned by them. (R. 39-40.)

The total authorized capital stock of the corporation was 100,000 shares, divided into 50,000 shares of preferred of the par value of \$100 each and 50,000 shares of common with no nominal or par value. The original articles of incorporation provided for the issuance of 23 series of 6½% cumulative preferred serial stock, to be designated by the letters A to W, both inclusive, each series to be for the number of shares shown (ranging between 1,100 and 3,950) and to be "redeemable at their par value plus all unpaid, accrued, or accumulated dividends thereon." Such cumulative preferred serial stock could be issued as and when the board of directors should determine, but it could not be issued except for the purpose of acquiring property suitable for one or more of the purposes of the corporation. The articles of incorporation also provided (R. 40):

* * * The aggregate indebtedness of the corporation secured by mortgage, deed of trust, or otherwise, shall not exceed in amount Fifty per cent (50%) of the appraised value of the property subject thereto. The total amount of preferred stock of the corporation at any time outstanding shall not, together with the total bonded indebtedness of the corporation, exceed One Hundred per cent (100%) of the appraised value of the property of the corporation * * *.

The 6½% cumulative preferred serial stock was “entitled to receive in each year out of the surplus or net profits of the business of the corporation, dividends at the rate of 6½% per annum, and no more, upon the par value of said stock from date of issue, payable quarterly * * *.” The dividends were cumulative and “if in any year or years the dividends * * * shall not have been paid, such dividends shall be paid in full before any dividends shall be paid or set apart upon the common stock. The amount of any serial redemption of said preferred stock, if overdue, shall be paid before any dividends shall be paid or set apart on the common stock.” (R. 41.)

In the event of liquidation, dissolution, or winding up of the corporation, the holders of the preferred stock were entitled, before any distribution could be made to the holders of the common stock, “to be paid out of the surplus profits * * *, or in case such profits shall be insufficient, then from the general assets of this corporation, an amount equal to 105% of the par value of said stock.” Upon the maturity date specified in each series the shares were to “be redeemed at par, plus unpaid, accrued, and accumulated dividends thereon * * *.” In the event the corporation should fail to redeem the stock at such time and place, the holders were to “have the right to enforce payment of the par value of said stock so agreed to be redeemed, together with the amount of any unpaid, accrued, or accumulated dividends thereon, the same as on any unconditional claim or debt against the corporation * * *.” The pre-

ferred stock was to have no voting power, the sole voting rights being vested in the holders of the common stock. In the event that any dividend on the preferred stock should not be paid when payable and should remain unpaid for 90 days, then so long as such dividend or any part thereof should remain unpaid, the issued and outstanding preferred stock was to be exclusively entitled to the voting power. (R. 41-42.)

Pursuant to the original articles of incorporation during the years 1923, 1924, and 1925, petitioner issued and sold 6½% cumulative preferred serial stock of the total par value of \$4,500,000 in 23 series designated A to W, inclusive. Series A matured and became payable on July 1, 1929, and one of the remaining series matured and became payable on July 1 of each year thereafter to and including the year 1951. The certificates were redeemable at par "plus all unpaid, accrued, or accumulated dividends thereon", and entitled the owners "to receive in each year out of the surplus or net profits of the business of the corporation, dividends at the rate of 6½% per annum, and no more, upon the par value of said stock from date of issue * * *." The certificates also contained the essence of article fourth of the original articles of incorporation, including the provisions quoted above. During the years 1924 and 1925 petitioner also issued and sold its 5½% coupon bonds of a total face value of \$3,000,000. The proceeds derived from the sale of the preferred stock and bonds were used for the purchase of real estate suitable for the purposes of the corporation. (R. 42-43.)

In connection with the issuance and sale of petitioner's 6½% cumulative preferred serial stock in 1923 a prospectus was published by the First Securities Company. Therein it was stated that petitioner proposed to issue at that time \$3,000,000 of 5½% first mortgage bonds and \$3,000,000 6½% cumulative preferred stock and to hold in its treasury the balance of the authorized preferred stock for issuance from time to time as the needs of the company should require. The prospectus also stated: "it is the intention of the Realty Company (petitioner) to finance its present needs by equal amounts of Preferred Stock and Bonds * * *. The annual maturities of bonds and stocks will serve to increase the original equity as the different series mature and are retired", and "The 6½% Cumulative Preferred Serial Stock is, in opinion of counsel, free from the Personal Property Tax in California and likewise free from the Normal Federal Income Tax." (R. 43-44.)

Series A of the 6½% cumulative preferred serial stock matured and was redeemed on July 1, 1929. Series B to G, inclusive, matured and were redeemed respectively on July 1 of each year thereafter to and including 1935. At the beginning of the year 1936 6½% cumulative preferred serial stock of a total par value of \$3,766,500 was issued, outstanding, and unmatured. During the year 1936 all of the securities were redeemed and retired. During the year 1936 petitioner made payments to holders of the 6½% cumulative preferred serial stock at the rate of 6½% per annum of the par value thereof, or \$65,300.63 as provided in the certificates. (R. 44.)

On December 16, 1927, petitioner's articles of incorporation were amended. A copy of article fourth as amended is attached to the stipulation of facts. There were no substantial changes made with respect to preferences, privileges, and other rights of the holders of preferred stock, but the amended article provided for a total authorized capital stock of 125,000 shares, divided into 75,000 shares of preferred stock of the par value of \$100 each and 50,000 shares of common stock having no nominal or par value. During the year 1928, pursuant to the authority contained in the article as amended, petitioner issued and sold its securities designated 5½% cumulative preferred serial stock of the total par value of \$1,000,000. The proceeds derived therefrom were used for the purchase of real estate suitable for the purposes of the corporation. The certificates were issued in 22 series designated AA to VV, inclusive, payable on July 1, 1939, and successively thereafter on July 1 of each year to and including the year 1960. Each certificate recited that on April 20, 1928, the board of directors "determined upon the issuance of \$1,000,000 (10,000 shares) fixed dividend rate, 5½%, fixed redemption premium, 2% (\$102.00 per share), designations and maturities as follows: (Schedule)." (R. 45.)

The prospectus issued in connection with the 5½% cumulative preferred serial stock stated (R. 46):

With the completion of the present stock sale, the Pacific Southwest Realty Company will have outstanding \$4,500,000 6½% Cumulative Preferred Serial Stock, and \$1,000,000 5½% Cumulative Preferred Serial Stock, in addition

to 50,000 shares Common Stock of no par value, owned by the First Securities Company.

With the completion of the present financing on or about July 2, 1928, there will be outstanding \$5,100,000 of first mortgage bonds. The aggregate total par value of outstanding preferred stocks and bonds will then be \$10,600,000.

The prospectus also stated that the stock being offered was, "in opinion of counsel, free from the Personal Property Tax in California and likewise free from the Normal Federal Income Tax."

During the year 1936 all of the 5½% cumulative preferred serial shares of the par value of \$1,000,000 were outstanding. All of them were redeemed and retired during the year 1937. During the years 1936 and 1937 petitioner made payments to the holders of the securities as provided in the certificates at the rate of 5½% of the par value thereof or \$55,000 during the year 1936 and \$41,250 during the year 1937. (R. 46.)

The payments made by petitioner to the holders of its 6½% cumulative preferred serial stock and 5½% cumulative preferred serial stock were authorized by resolutions of the board of directors of petitioner. A true copy of one of the resolutions is attached to the stipulation. It declares a "regular quarterly dividend of \$1.37½ a share on the 5½% Cumulative Preferred Serial Stock of this corporation, amounting to \$13,750 * * * out of the earned surplus of the corporation" and directs "that the amount thereof be set aside and transferred to 'Dividend Declared' account." (R. 46-47.)

The 5½% cumulative preferred serial stock had been sold by the petitioner at discounts of \$3 and \$5 per \$100 par value, the discount aggregating \$46,858. It is stipulated that if the discount at which the securities were sold was a deductible expense, it was an expense which it was proper to amortize and deduct over the life of the securities and \$1,833.26 of the discount expense was properly allocable to the year 1936 and \$31,275.39 was properly allocable to the year 1937. (R. 47.)

During the year 1936 petitioner redeemed and retired all of its then outstanding 6½% cumulative preferred serial stock for the face value thereof (\$3,766,500) plus a total premium of \$182,025. During the year 1937 it redeemed and retired all of its then outstanding 5½% cumulative preferred serial stock for the face value thereof (\$1,000,000) plus a total premium of \$20,000. (R. 47.)

In its income tax return for the year 1936 petitioner failed to take deductions for the payments made on its securities designated 6½% cumulative preferred serial stock and 5½% cumulative preferred serial stock, failed to take deduction for the portion of the discounts at which its securities designated 5½% cumulative preferred serial stock were issued and sold which was allocable to the year 1936, and failed to take a deduction for the premium paid upon the redemption of its securities designated 6½% cumulative preferred serial stock. In its income tax return for the year 1936 petitioner reported net taxable income in the amount of \$562,740.52 and a tax

liability in the amount of \$83,251.08. Petitioner paid this tax in installments as follows: \$20,812.77 on March 15, 1937, and like amounts on June 12, September 13, and December 13, 1937. Petitioner's return for the year 1936 was filed on March 15, 1937. (R. 48-49.)

Upon examination of petitioner's income tax return for the year 1936 the Commissioner disallowed the deduction taken by petitioner for real estate taxes in the amount of \$5,618.35 and determined the net income of petitioner for the year 1936 to be \$568,358.87. The deficiency for the year 1936 in the amount of \$842.75 resulted from the disallowance of the deduction and the consequent increase in petitioner's net income. This item is not involved in this appeal. (Pet. Br. 9.)

On March 6, 1940, petitioner filed with the Collector of Internal Revenue for the Sixth District of California, at Los Angeles, California, its written claim for refund of income taxes overpaid by it for the year 1936 in the amount of \$53,900.53, setting forth therein the same facts and grounds herein relied upon. (R. 49-50.)

In its income tax return for the year 1937 petitioner deducted as interest paid the payments made on its securities designated 5½% cumulative preferred serial stock in the amount of \$41,250, deducted the sum of \$31,275.39 as the portion of the discount at which the securities were issued and sold which was properly allocable to the year 1937, and deducted the premium paid in the amount of \$20,000 upon the redemption of the securities. The Commissioner refused to allow these deductions. (R. 50.)

On May 22, 1940, petitioner paid to the Collector of Internal Revenue for the Sixth District of California the deficiencies in income taxes proposed to be assessed against it for the years 1936 and 1937. The payments were as follows: \$842.75 tax and \$161.09 interest, or a total payment of \$1,003.84 for the year 1936, and \$13,878.81 tax and \$1,820.21 interest, or a total payment of \$15,699.02 for the year 1937. (R. 50.)

The Board of Tax Appeals sustained the deficiencies as determined by the Commissioner. (R. 65.)

SUMMARY OF ARGUMENT

The Board of Tax Appeals properly concluded that the distributions made to the holders of petitioner's "preferred serial stock" were dividends and not interest on indebtedness within the meaning of Section 23 (b) of the Revenue Act of 1936. In allowing a deduction for interest paid, Congress contemplated an indebtedness as normally regarded. The distributions here fall within the specific letter of the statutory definition of dividend. Accordingly, the petitioner assumed quite a burden in asking this Court to reverse the Board of Tax Appeals and hold that the distributions were not what they seem but were in reality interest payments.

In the instant case, the provisions of the charter, the prospectus, the certificates of stock, and the other documentary exhibits may be given their ordinary meaning, in classifying the distributions in question, since there is no showing here by evidence *aliunde* the documents of any special intention to enter into an arrangement other than that which the documents themselves would

normally indicate. All factors point to the conclusion that the relationship was that of a preferred stockholder, with the possible exception of the fact that there was a fixed redemption date, after which the holder had an unrestricted right to enforce the obligation. This Court has ruled that this fact does not of itself constitute the holder a creditor.

ARGUMENT

The Board of Tax Appeals properly concluded that the distributions made to the holders of petitioner's "preferred serial stock" were dividends and not interest on indebtedness within the meaning of Section 23 (b) of the Revenue Act of 1936

The question presented herein is very simple: Whether the distributions called "dividends" were in fact and substance dividends on preferred stock or interest on indebtedness. However, the answer is not as simple as the petitioner's counsel suggests. The decisions of the Court, on which the petitioner relies primarily, in *Commissioner v. Proctor Shop*, 82 F. (2d) 792, and *Commissioner v. Palmer, Stacy-Merrill, Inc.*, 111 F. (2d) 809, are based upon unique facts and are clearly distinguishable.

In the *Proctor Shop* case evidence *aliunde* the contract showed a very definite reason (to avoid the usury statute) for calling the instrument preferred stock instead of a bond. The Board there found that the recipient of the instrument was willing to lend money to the corporation (provided he could get a high return for his money), but he was not willing to invest in the business, and the Board concluded that

from this and other factors (including the fixed maturity date) the so-called "debenture preference stock" was in reality evidence of an indebtedness rather than a proprietary interest.

Likewise in the *Palmer, Stacy-Merrill, Inc.* case, *supra*, "evidence *aliunde* the contract" was relied upon to show the real substance of the transaction as one of indebtedness. It is to be noted that in both this and the *Proctor Shop* case, *supra*, the Board of Tax Appeals had made findings of fact which indicated the real nature of the transaction between the parties. General Fruit Company wished to buy the business of some of its competitors. The competitors wished to sell for cash, but the General Fruit Company did not have sufficient cash to consummate the deal. The competitors finally consented to accept so-called preferred stock, of a new corporation, on the purchase price provided a specified percentage be redeemed each year, which undertaking was required to be guaranteed by General Fruit Company. The real substance of such transaction was that the competitor companies were selling their business and were to be paid over a fixed period of years. In the face of such evidence, the fact that the transaction took the form of preferred stock was not controlling. In reality there was an indebtedness for the purchase price.

The facts in the above cases, on which this Court predicated its decisions, are not at all comparable with those of the instant case. All of the other cases cited by the petitioner are likewise distinguishable in some essential factual point. Many decisions have been ren-

dered on this question generally, falling to one side or the other, depending upon the particular facts of each case. Wholesale citations of such decisions would add little to this discussion as this Court is undoubtedly familiar with the general principles to be applied and is fully aware of the fundamental rule that each case must be decided on the basis of its own facts. Accordingly, we will limit our subsequent discussion of cases to those directly bearing on the primary factor on which this petitioner relies to show indebtedness, i. e., the fact that the preferred stock here had a fixed date for redemption.

At the outset, this Court should bear in mind that this is a deduction case and that in all such cases it is incumbent upon the taxpayer to bring himself squarely within the scope of the statute allowing the deduction. In allowing a deduction for interest paid, Congress contemplated an indebtedness as normally regarded. In this connection the following excerpt from the recent decision of the Supreme Court in *Deputy v. du Pont*, 308 U. S. 488, seems particularly pertinent (p. 497-498):

There remains respondent's contention that these payments are deductible under section 23 (b) as "interest paid or accrued * * * on indebtedness." Clearly respondent owed an obligation to the Delaware Company. But although an indebtedness is an obligation, an obligation is not necessarily an "indebtedness" within the meaning of section 23 (b). Nor are all carrying charges "interest." In *Old Colony R. C. v. Commissioner*, 284 U. S. 552, this Court

had before it the meaning of the word "interest" as used in the comparable provision of the 1921 Act (42 Stat. 227). It said, p. 560, "* * * as respects 'interest,' the usual import of the term is the amount which one has contracted to pay for the use of borrowed money." It there rejected the contention that it meant "effective interest" within the theory of accounting or that "Congress used the word having in mind any concept other than the usual, ordinary and everyday meaning of the term." p. 561. It refused to assume that the Congress used the term with reference to "some esoteric concept derived from subtle and theoretic analysis." p. 561.

We likewise refuse to make that assumption here. It is not enough, as urged by respondent, that "interest" or "indebtedness" in their original classical context may have permitted this broader meaning. We are dealing with the context of a revenue act and words which have today a well-known meaning. In the business world "interest on indebtedness" means compensation for the use or forbearance of money. In absence of clear evidence to the contrary, we assume that Congress has used these words in that sense. In sum, we cannot sacrifice the "plain, obvious and rational meaning" of the statute even for "the exigency of a hard case." See *Lynch v. Alworth-Stephens Co.*, 267 U. S. 364, 370.

Petitioners throughout have referred to these payments by respondent as being capital in nature. * * *

* * * * *

Thus it was not enough for the petitioner here to show that the holders of its "preferred serial stock"

enjoyed rights beyond those ordinarily given to stockholders. The fact that the issuing company assumed some additional definite obligation, which might well be enforceable as between the immediate parties, is not decisive of the present question. As pointed out in the *du Pont* case, *supra*, every obligation is not an "indebtedness" within the meaning of Section 23 (b), *supra*. It is incumbent upon the petitioner, in order to prevail here, to show that the holders were creditors in the full sense of the word.

If the distributions here are dividends, rather than interest on indebtedness, in the ordinary business sense, the deduction cannot be allowed. It should be noted that in Section 115 (a), *supra*, Congress defined the term "dividend" to mean any distribution made by a corporation to its stockholders out of its earnings or profits. It was specifically provided here that the "dividends" were to be paid (R. 150) "out of the surplus or net profits of the business". It seems obvious, therefore, that the distributions here fall within the specific letter of the statutory definition of dividend. Accordingly, the petitioner assumes quite a burden in asking this Court to reverse the Board of Tax Appeals and hold that the distributions were not what they seem but were in reality interest payments.

In the instant case, the provisions of the charter, the prospectus, the certificates of stock, and the other documentary exhibits may be given their ordinary meaning, in classifying the distributions in question, since there is no showing here, as there was in the *Proctor Shop* and *Palmer, Stacy-Merrill* cases, *supra*,

by evidence *aliunde* the documents of any special intention to enter into an arrangement other than that which the documents themselves would normally indicate. In so finding, the Board of Tax Appeals pointed out (R. 53) that the facts disclosed an intention by the company and a willingness by the stockholders to assume the stockholder, rather than the creditor, relationship.

A brief reference to such documents seems appropriate at this point. In the petitioner's Certificate of Incorporation it was provided that (R. 146) the authorized capital stock should be 100,000 shares, divided into 50,000 shares of preferred stock and 50,000 shares of common stock, and that (R. 147) such preferred stock should be designated "6½% Cumulative Preferred Serial Stock". The charter further provided (R. 148) that the indebtedness "secured by mortgage, deed of trust, or otherwise" shall not exceed 50% of the appraised value of the property, and that the total amount of preferred stock shall not, together with the bonded indebtedness, exceed 100% of the appraised value of the property. The charter further provided (R. 150) that the specified dividends on the preferred serial stock should be paid "out of the surplus or net profits of the business". It was also provided that specified series of the stock were redeemable at specified times (R. 147), and that, after the redemption date, the holders might proceed against the company to enforce the obligation to redeem (R. 153) "the same as on any unconditional claim or debt against the corporation".

It seems clear that a stockholder, rather than a creditor, relationship was contemplated throughout the transaction. Every factor points toward the status of preferred stockholder, with the exception of the last one referred to. Even if it were assumed here that the preferred stockholder became a creditor to that extent after maturity and default under the redemption obligation, his status during the life of the agreement in which the distributions in question were made would still be that of a preferred stockholder. In the field of corporate financing, legal advisors are generally very careful to differentiate between a stockholder and a creditor relationship, to the end that the credit of the corporation be maintained and the continuance of its business protected from creditors' suits in troublesome times. It is to be noted that (R. 166) all legal proceedings pertaining to the issuance of this stock were approved by the law firm of Farrand and Slosson, Los Angeles, and that (R. 163) in the opinion of counsel the "dividends" were exempt from normal federal income tax (which would not have been the case if they really constituted interest on indebtedness). Obviously, such counsel used the terms "preferred stock" and "bonds" in their ordinary business sense, and in no way contemplated at the time of issuance that the distributions termed "dividends" would be classified as interest on indebtedness. As pointed out by the Board (R. 55) it is not without significance that the petitioner treated the payments as dividends upon its books and in all of its tax returns up to and including 1936, the first of the two years here involved.

Other factors supporting the Board's conclusion are set forth in the lengthy statement of facts and need not here be repeated. As pointed out by the Board (R. 53) all factors point to the conclusion that the relationship was that of a preferred stockholder, with the possible exception of the fact that there was a fixed redemption date, after which the holder had an unrestricted right to enforce the obligation. As indicated earlier in the brief, the discussion of cases will be limited to those involving this factor.

In the case of *In re Culbertson's*, 54 F. (2d) 753, this Court faced a problem similar to that here involved. The claim there presented was that (p. 754):

* * * these certificates were in such form and issued in such manner that although denominated "certificates of preferred stock" they were in fact certificates of indebtedness entitling the holder thereof to participate as a creditor in the assets of the bankrupt corporation.

This Court there made these pertinent observations (p. 755):

* * * at the outset we find it difficult to believe that where an individual has purchased a number of shares of preferred stock in a corporation, the certificates issued to him for such preferred stock, designating the number of shares he purchased and the par value thereof, were nevertheless, by reason of the terms thereof, in fact certificates of indebtedness. On this appeal there are involved only three classes of certificates, designated as class "A," class "B," and class "D" certificates, respec-

tively. As already pointed out, these certificates, were in the usual form of stock certificates. Each and every of them stated the amount of the capital stock of the corporation, the number of shares into which divided and the number of shares covered by the certificate, provided for the payment of dividend at a specified per centum per annum, payable on specified semiannual dates, and contained a provision to the effect that until such dividend should be paid no dividends should be paid on the common stock. Each and every certificate herein involved contained a provision to the effect that the preferred stock has no voting power, and also a provision for the retirement of the stock covered by the certificate; the terms of this last-mentioned provision varying somewhat in the different classes, as later specified herein.¹

The following solution of the problem as presented by this Court in that case might well be adopted in solving the very similar problem here (p. 756, 757):

It is contended on behalf of appellants that this agreement to repay the value of the stock and dividends constitutes evidence of a loan to be repaid at the time and at the rate of interest therein designated. But it is not permissible to segregate one clause of the agreement and base a judicial decision thereon. It is apparent

¹ The Court said (p. 756): The provisions just referred to, as they are contained in the class A certificates, are as follows: "The said Company will on ----- 19-- pay to the holder of this certificate the par value thereof, together with such dividends as is hereinafter provided for. * * *"

that it was the intention of the parties that these certificates should evidence the right of the holders thereof to participate in the earnings of the corporation as holders of preferred stock entitled, by reason thereof, to receipt of the agreed proportion of the net earnings they were to receive before holders of common stock were entitled to share in such earnings. * * * there is nothing in the certificate in question which justifies the conclusion that it was intended to be other than what it purported on its face to be, namely, a certificate of preferred stock. * * *

* * * * *

If, as we have held, this agreement constituted the holder thereof a stockholder, the fact that it provides for the redemption of a certificate does not constitute the holder a creditor (14 C. J. 417), * * *

In the earlier case of *Armstrong v. Union Trust*, 248 Fed. 268, this Court was likewise presented with the question whether the holders of certain "preferred stock", which the issuing corporation agreed to redeem at the end of five years, were stockholders or creditors. The remarks there made are equally pertinent here (p. 270, 271):

The company appreciated very well the difference between certificates of indebtedness and preferred stock, as it, by its board of directors, provided for the creation of each kind of liability. Capital stock has a distinct characteristic, and represents the capital upon which the corporation is authorized to do business. It may be paid up, or merely subscribed. If the latter,

the subscriber is liable to the company for its par value, and it constitutes one of the assets of the company, to all of which creditors may look for payment of their demands. A certificate of indebtedness is therefore quite a different thing from a certificate of capital stock in a corporation. The one represents a liability of the company to the creditor; the other a liability to the stockholder, who has contributed of his means to the capital of the corporation, and has become in that respect a party to the venture. * * *

* * * * *

Looking back of this to the records of the corporation, we find that the capital stock was increased and fixed at \$1,000,000, of which 2,000 shares, or \$200,000, were to be preferred. The \$200,000 was therefore designed as, and was directly declared to be, a part of the capital stock of the corporation. So that a person, in negotiating for and acquiring this preferred stock, became a contributor to the capital stock of the company. He thus signified his desire and purpose to participate in the venture of carrying on the business for which the company was incorporated, and his willingness to share in the profits it might derive and the losses it might sustain in engaging in the enterprise. These certificate purchasers must be held to full knowledge and appreciation of the real character of their investments, and that they were to become participants in the enterprise, and not mere creditors of the corporation. To intimate otherwise would be to impugn their intelligence. * * *

From a review of the entire situation

we conclude that these certificate holders are stockholders—preferred stockholders, as the certificates indicate—and not creditors. * * *

In reaching the above decision, this Court cited approvingly *Ellsworth v. Lyons*, 181 Fed. 55 (C. C. A. 6th), and *Spencer v. Smith*, 201 Fed. 647 (C. C. A. 8th), which are frequently cited on this point. In the *Ellsworth* case, *supra*, though likewise involving a creditor proceeding and not a tax case, the problem presented was the same and the facts very clearly parallel those of the case at bar. There the “preferred stock”, which was issued in 1902, provided that it shall be retired June 1, 1912. The court there rejected the contention of the holder that he was not in reality a stockholder at all, but essentially a creditor.

In *Kentucky River Coal Corp. v. Lucas*, 51 F. (2d) 586, affirmed *per curiam*, 63 F. (2d) 1007 (C. C. A. 6th), the court applied these same principles to an income tax case. The taxpayer there insisted that the unconditional undertaking on the part of the corporation to redeem certain preferred stock at the expiration of ten years gave such shares the characteristics of a debt. In denying this claim, the court pointed to the fact that the stock was listed in the charter as part of the capital stock structure (as it was here) and the stipulated dividend was to be paid only out of surplus profits and earnings (as it was here). With respect to the obligation to redeem at a fixed date, the court observed that while the stockholders among themselves could make such an agreement, the courts would likely rule that the rights of such holders were

subordinate to the rights of general creditors. See also to the same effect *Finance & Investment Corp. v. Burnet*, 57 F. (2d) 444 (App. D. C.).

In *Jewel Tea Co. v. United States*, 90 F. (2d) 451 (C. C. A. 2d), the court indicated that some doubt had arisen in its mind on this question and suggested that the broad rule of its former decision in *Commissioner v. O. P. P. Holding Corp.*, 76 F. (2d) 11, should be limited. In the *Jewel Tea Co.* case that court said (p. 453):

Possibly *Commissioner v. O. P. P. Holding Corporation*, *supra*, 76 F. (2d) 11, does not commit us to the doctrine that shares must under all circumstances be debts when they contain a provision that the holder may unconditionally demand his money at a fixed time. Courts have differed as to that. At times they have gone to lengths to construe such a power as limited to a surplus. *Hazel Atlas Glass Co. v. Van Dyk & Reeves*, 8 F. (2d) 716 (C. C. A. 2). At times they have thought such an agreement unlawful under local law; or, even if lawful, not of itself enough to make the shareholder a creditor. *Fidelity Savings & Loan Association v. Burnet*, 62 App. D. C. 131, 65 F. (2d) 477; *In re Culbertson's*, 54 F. (2d) 753 (C. C. A. 9); *Kentucky River Coal Corporation v. Lucas* (D. C.) 51 F. (2d) 586; *Id.*, 63 F. (2d) 1007 (C. C. A. 6). All we now decide is that in the absence of such a provision the security cannot be a debt.

On the nature and general effect of rights based upon fixed redemption dates, particularly where the rights of general creditors are involved (which pre-

sents the real test of whether the holder is a creditor in the full sense or merely a preferred stockholder who has special rights), see the frequently cited case of *Koeppler v. Crocker Chair Co.*, 200 Wis. 476; *Bates v. Daley's, Inc.*, 5 Cal. App. (2d) 95; *Fletcher, Cyclopedia Corporations* (Perm. Ed.-1932), Vol. 11, pp. 722-738.

CONCLUSION

The decision of the Board of Tax Appeals is correct and should be affirmed.

Respectfully submitted.

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